

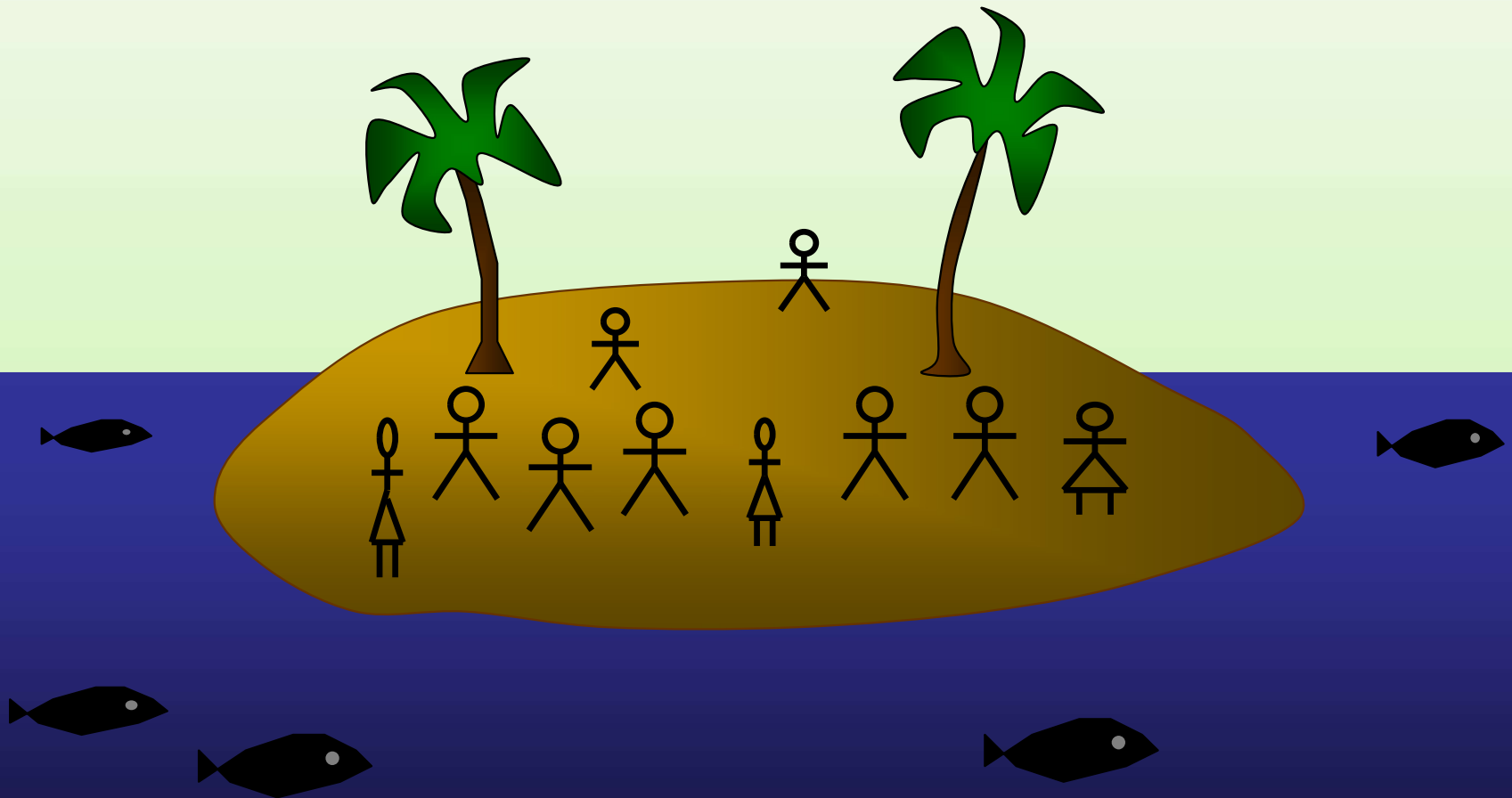
# **The Story of an island**

## Scene 1

100 people marooned on an island

Question:

What will these marooned islanders do first?



Arrange for food

So, all hundred people engage themselves in  
Food hunting/growing

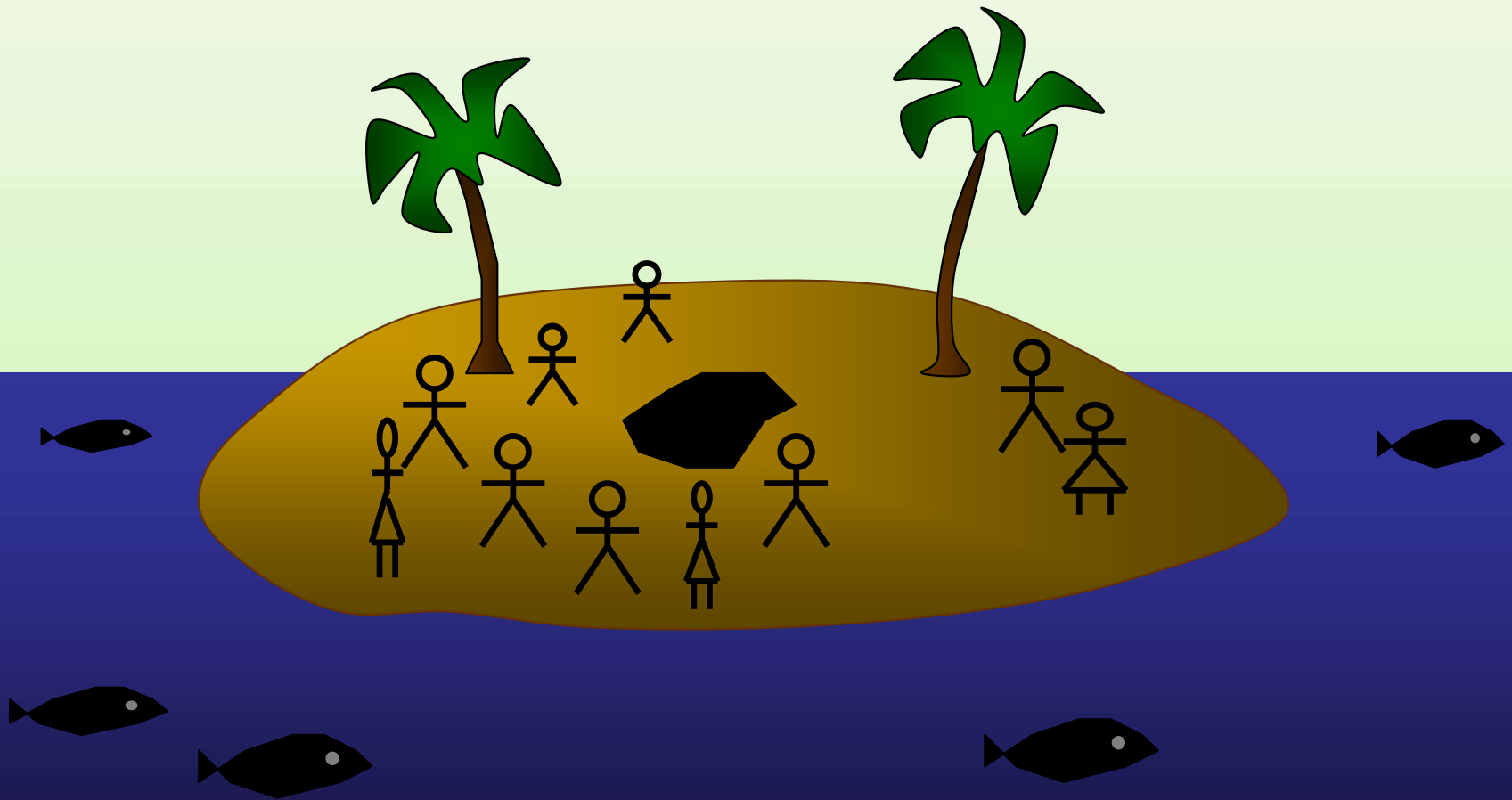
**Some time later**

**To be precise, one period later**

## Scene 2

They produced more food than they needed  
Enough to feed 125 people

Question:  
What will they do next?



**Somebody will use his/her brain and say - let us not all engage in food hunting. Since we produced enough to feed twenty five more people this year, I feel that if only eighty of us worked for food and the remaining twenty made tools to make the job of the first 80 easier, then we will all be better off.**

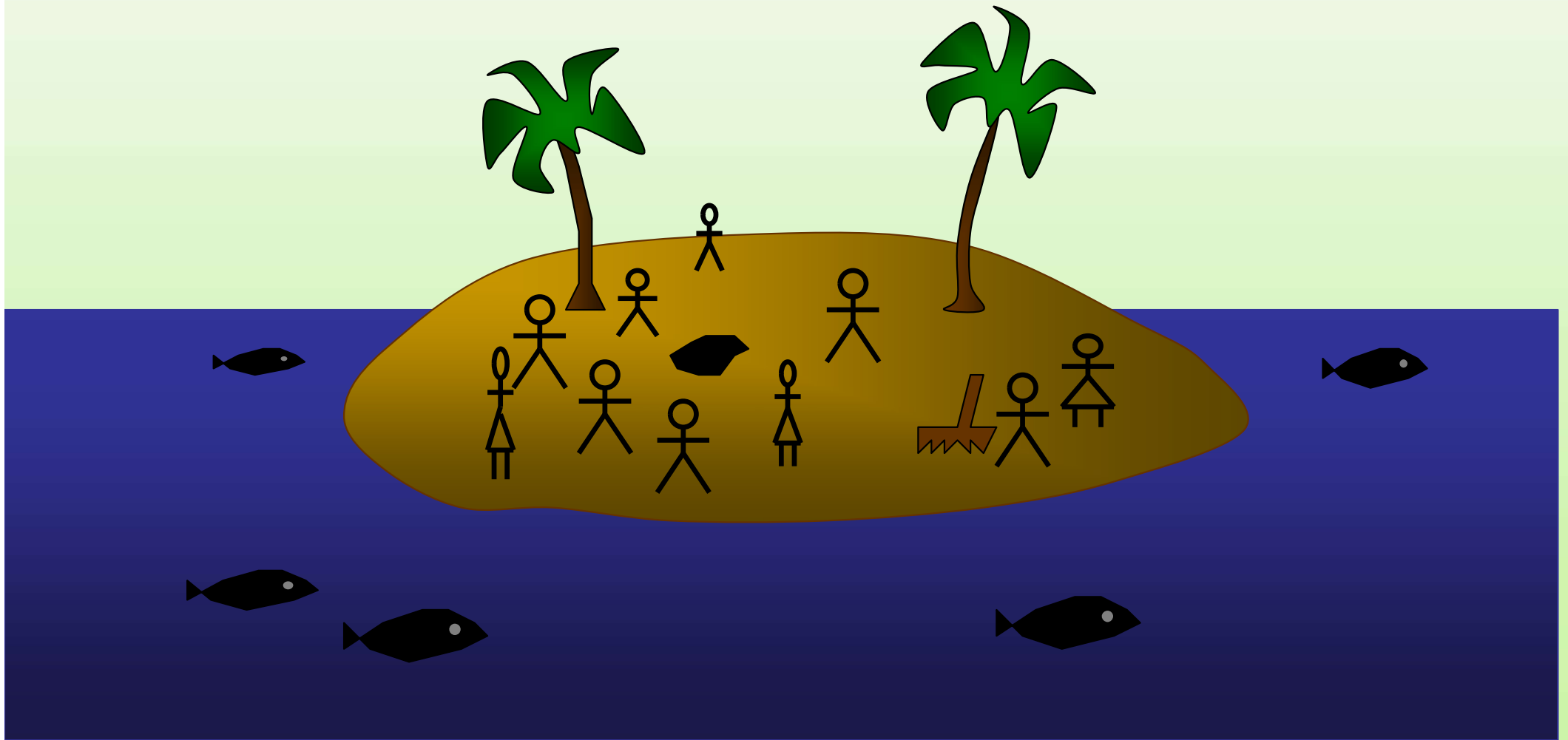
**We now have two industries on the island - a food industry and a tools industry. Eighty, Twenty.**

**Two periods later**

### Scene 3

They produced just enough food and they produced some tools.

Question: What will they do next?





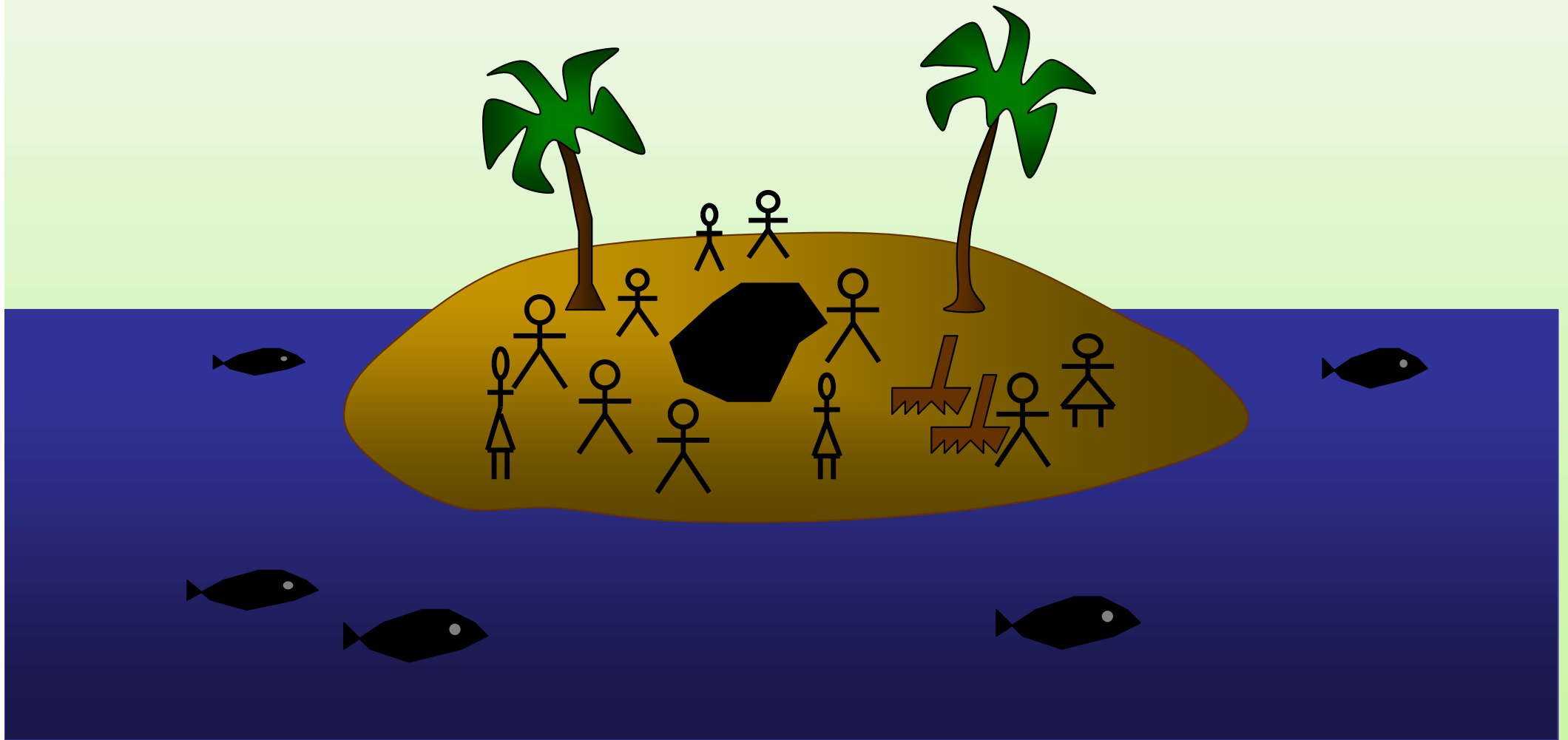
**They enter the third period still with 80/20**

**Three periods later**

## Scene 4

They have food for 150 people. And they have more tools.

Question: What will they do next?



**Somebody decides**

**Only fifty people should engage in food hunting**

**Twenty should continue to make better tools**

**Thirty should make homes for all of us.**

- That way we will all be even better off.**

**And so on**

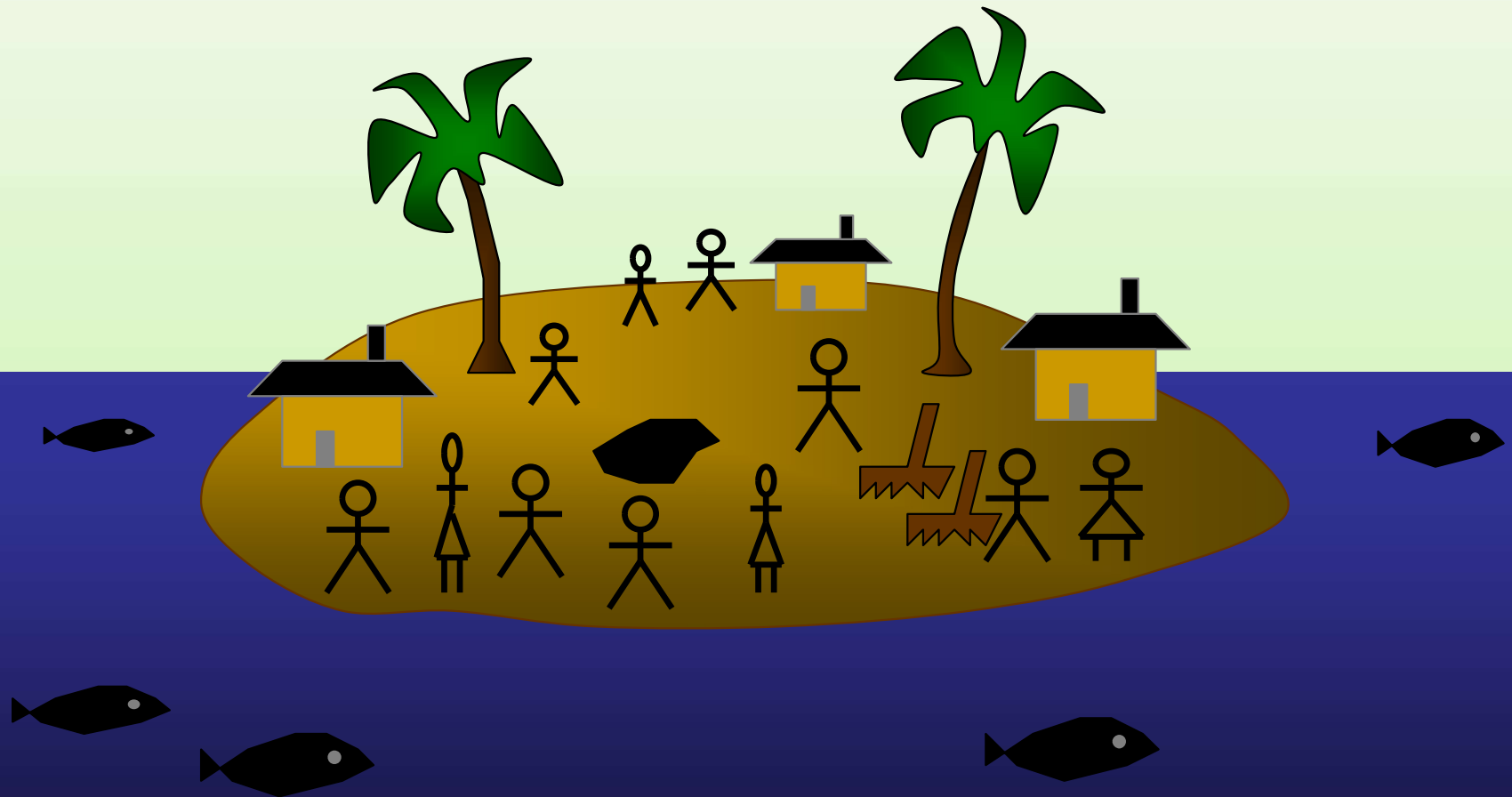
**Twenty periods later**

## Scene 5

They have food just enough for 100 people.

They have tools

They have houses



- Only 25 people are working in the food industry
- 10 people are making houses
- 15 people are making tools
- 10 are studying better ways of making tools
- 10 are learning how to make tools and houses
- 15 have quit working because they are too old. Other eighty five will feed them - a reward for their service.
- 5 people are teaching others how to hunt for food, how to make tools/houses etc.
- 3 people are just making decisions about the next period
- 6 people are engaged in arts and entertainment.
- One person is wondering about the meaning of life



What elements of economic evolution do we see in this island story?

Increase in productivity

Division of labor

Exchange of goods and services

Birth of new industries

Firing

Hiring

Improvement in the standard of living

Indulgence in the arts and philosophy

Resource allocation decisions

Decision making

# Island to Country

- **Substitute the island with a country**
- **Substitute 100 people with 80 million people.**
- **Substitute 20 periods with 20000 periods**
- **Substitute 5 industries with 50000 industries**
- **What you get is today's typical economy.**

# Role of Decision Making

- What role did “Resource allocation decisions” play in this economic evolution?
- What would be the effect of “poor decisions?”
- How were these decisions made?
- What would be the effect of “poor information?”
- How does decision making change as the size of the island increases?

# From Central to Decentralized Decision Making

- As the size of the island increases, the quality of information if collected centrally reduces.
- Therefore the quality of decisions deteriorates.
- Information gathering and decision making needs to be **decentralized**.
- Each business entity must have its own system of gathering data and producing information and making decisions.

## Scene 6

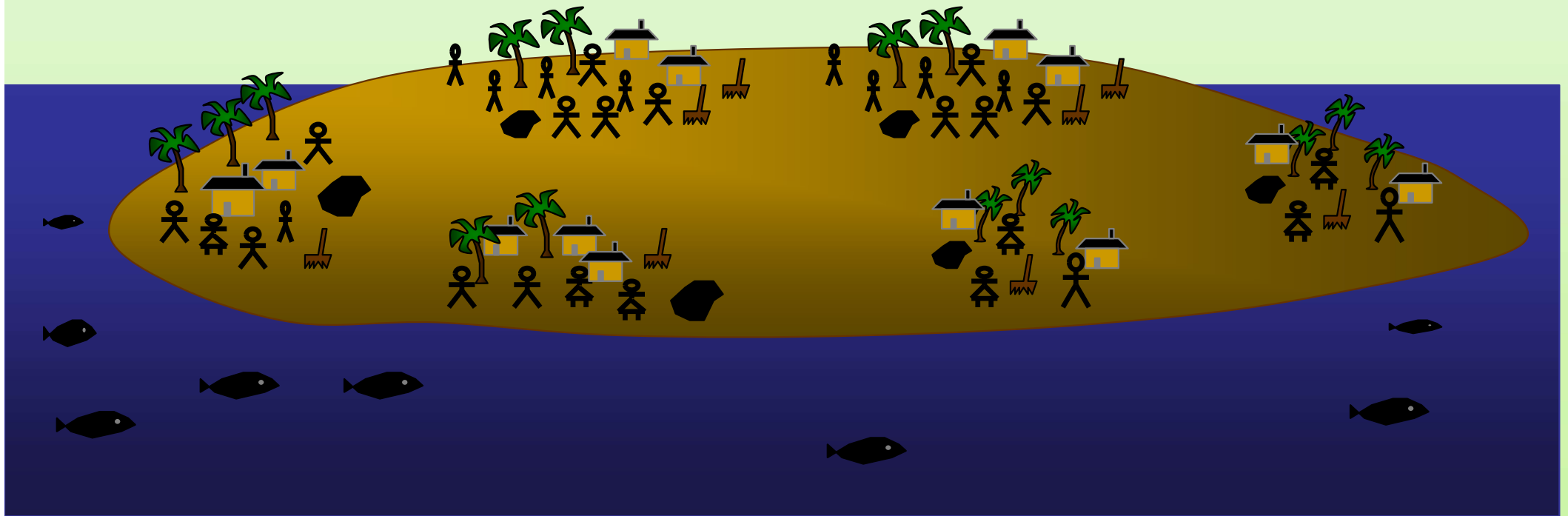
The island is much bigger – almost like a country or a continent

There are many cities

Production is distributed geographically

Consumption is distributed geographically

Decision making is decentralized

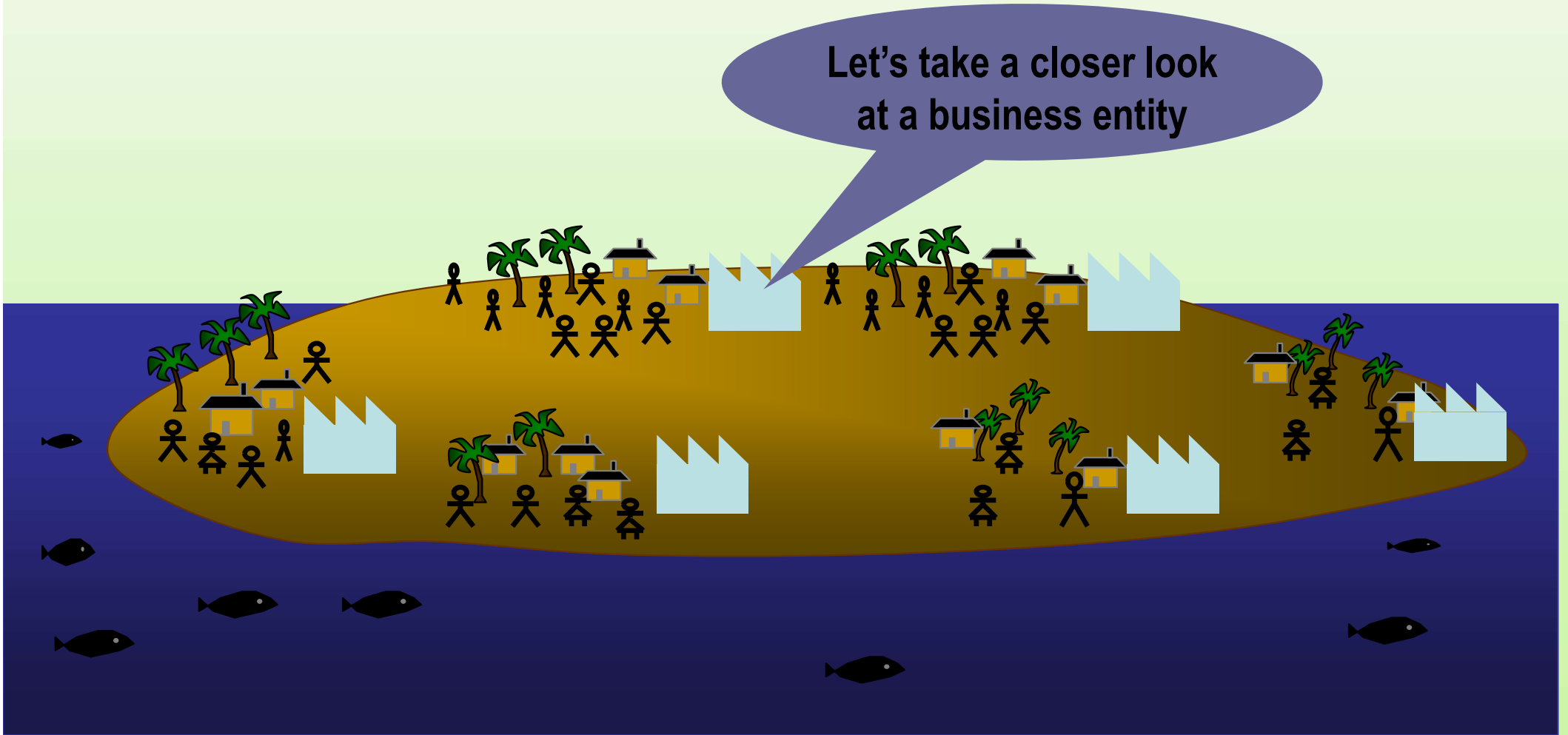


## Scene 7

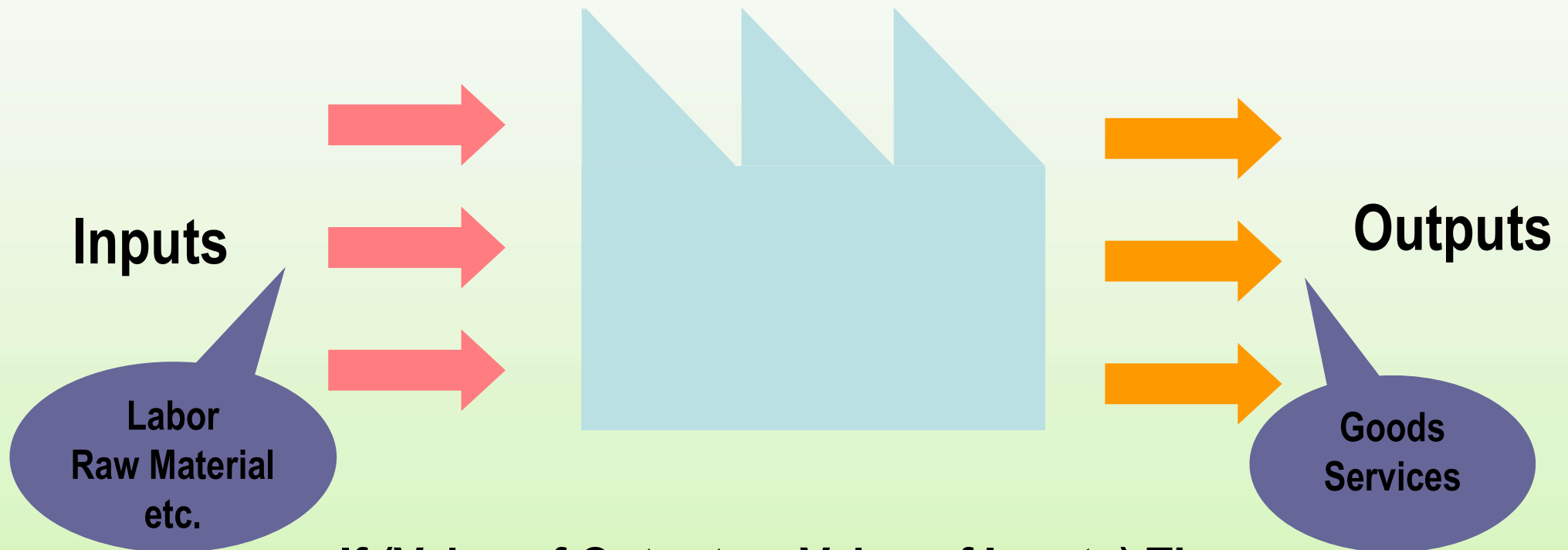
Production centers have been created

These “Production centers” can also be called **business entities**

Let's take a closer look  
at a business entity



# A Business Entity (System)



**If (Value of Outputs > Value of Inputs) Then**

**Business Entity lives**

**Else**

**Business Entity dies**

**This is only possible if  
a business runs its  
operations efficiently**